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The Manufacturers Hanover Economic Report

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Economic Forecast for 1981

This is traditionally the time during which economists crank up their mathematical models, activate their computers or, simply, peer into their crystal balls in an effort to aid their employers, clients or whoever in planning for the year ahead. I have never known there to be an "easy time" to forecast, but, it seems to me, this time is more difficult than most. This is because there is not only the usual amount of uncertainty over where the economy is going — there is a great deal of confusion where we have been!

If one looks no further than some of the recent economic statistics, one might have reason to believe that the 1980 recession came to an end sometime last summer. Retail sales have been climbing since June, fueled by a recovery in two major industries — homebuilding and automobiles. Employment has climbed by 670,000 since June, while the unemployment rate has dropped by several tenths of one per cent. Personal incomes are up by \$69 billion, while industrial production has climbed by 1.6 per cent since July. Needless to say, these rising monthly numbers were enough to push up the overall economy by an annual rate of one per cent in the third quarter, as measured by the change in the gross national product adjusted for inflation.

Leaving aside, for the moment, the question of whether or not these numbers accurately portrayed the state of the economy during the third quarter, there is still a question in my mind regarding the course of the economy because these rising statistics have been accompanied by two other statistics which have gone up: interest rates and the rate of inflation. It is most unusual for interest rates and the rate of inflation to pop up at this point in the cycle. If the recession is still on, rising interest rates and higher inflation rates will only worsen and prolong it. On the other hand, if recovery has, indeed, gotten under way, then the uptrend in interest rates and the rate of inflation are sure to weaken it — if not abort it altogether.

Business Remains Sluggish

I, for one, do not think the recession ended during the summer. I think the uptrend in many of the economic statistics of the third quarter represents nothing more than a rebound from the lows created artificially by the imposition of credit controls by the Federal Reserve. As has been well documented by now, many people misinterpreted the intent of the Fed's credit controls to mean that no credit was available whatsoever. Since four out of every ten dollars' worth of retail goods are purchased with the use of credit, and since consumer spending accounts for two thirds of the gross national product, it is easy to see how such a misunderstanding could lead to a sharp drop in economic activity during the second quarter. By the same token, it should have been expected that, once the controls were lifted, some deferred spending would have taken place, pushing up those statistics that deal with consumer spending, and, by extension, the overall economy.

Aside from the question of how to interpret the bounceback from the controls-induced low, there are concerns over the accuracy of some of these numbers. For example, the rise in several of the components of the retail sales figures for September appears to be at variance with similar numbers reported from other sources. In the case of September's preliminary estimate for retail sales, the largest contributor to the 1.6 per cent increase in the overall numbers was the six per cent rise in sales by automobile dealers. However, according to registrations reported by Ward's Automotive Reports, auto sales retreated in September, seasonally adjusted, to a 6.2 million unit annual rate from a 6.8 million unit clip in August. Furthermore, prices of new cars declined as manufacturers provided yearend discounts and rebates in order to help clear leftover 1980 models. Plainly, falling units and a lower average price do not, in my view, add up to a higher dollar figure the way the Commerce Department reported it initially.

Incidentally, the decision by the Bureau of Labor Statistics to include yearend discounts on leftover 1980 model cars in September's Producer Price Index created quite a stir. Granted, the Labor Depart-



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ment had been moving away from reliance on list prices and toward transactions prices in an effort to make the PPI a more accurate reflector of price trends—especially during periods of soft economic activity when discounts are widespread. However, it is interesting—if not suspicious—that the BLS chose September to include transactions prices on new cars. This is because these discounts are by and large a once-a-year phenomenon, thus, are impossible to seasonally adjust. What is more, when the 1981 model car prices are included in October's PPI, they will reflect a substantial increase, not only because Detroit raised prices on the new cars—but also because the increase will be percentaged against the lower discount base in September's Index.

Getting back to the retail sales statistics, another component that the Commerce Department said went up was sales by gasoline service stations. This, too, raises some questions, since the American Petroleum Institute said that gasoline consumption continued its downward trend in September while prices, as measured by both the Producer Price Index and the Consumer Price Index, declined. Of course, this drop in the dollar value of gasoline purchased could have been offset by a large gain in purchases of such automobile parts as tires, batteries or accessories. However, this seems to be unlikely, in view of the sharp cutback in driving that has been underway for some time in reaction to the recession and the high price of gasoline.

There are other questions that can be raised. For example, a good part of September's eight per cent increase in new orders for durable goods reflected a strong rise in transportation equipment orders, which in turn, were driven up by orders for defense equipment. Ordinarily, defense spending accounts for four per cent of factory hardgoods' orders. However, in September, defense spending contributed more than one-third to the increase. Since September marks the end of the Federal government's fiscal year, it could be that some last-minute ordering came from the Defense Department in order to use up funds left over from the fiscal year's allocation.

This same Federal force-feeding apparently affected September's housing starts numbers. In the face of a return of mortgage interest rates past the 14 per cent zone—a level that earlier this year caused both borrowers and lenders to back away and housing to collapse—housing starts recorded a surprising increase of nine per cent. Virtually all of this rise, however, reflected a bulge in Federally-subsidized units, prompted by special encouragement by several government agencies. Single-family home starts, which currently account for nearly three quarters of new-home construction, remained virtually unchanged in the month.

But let us, for the moment, overlook these inconsistencies and concentrate on what the current batch of numbers mean for the outlook. It would seem to me that these upticks are a far cry from the start of an economic recovery. Most of these numbers remain far below levels reached before the onset of recession. As was demonstrated during the 1973-75 recession, it takes more than a few months' uptrend to get the economy out of recession if the underpinnings are weak. As for the rise in the real gross national product, it might be unusual—but it is not unprecedented for the GNP to rise in the middle of a recession. It happened once, during the 1948-49 recession—and twice in the middle of the 1970 recession.

Where Will Strength Come From?

What I am saying is that for the third quarter's upturn to be considered the start of a new expansion, the economic statistics must continue to rise. Growth for the economy can come from one or more of four major sectors: consumers, domestic business, exports and government. Let us now examine each sector to determine which, if any, can be expected to impart strength to the economy.

Consumers have three basic sources of funds that can be used to purchase goods and services. They can rely on their current incomes, dip into savings (either by withdrawing funds from their banks, or by selling off financial assets) or by borrowing. Looking at the first, we find that, while incomes are growing by 10.3 per cent per annum, prices, as measured by the GNP version of the Consumer Price Index, the PCE deflator, are going up by 10.5 per cent, suggesting continued declines in buying power. Of course, people could dip into their savings. But the national income accounts numbers suggest that the savings rate, while up somewhat from the 30-year low recorded at the turn of the year, is nonetheless well below normal. Not only that, it is about half the rate that prevailed at this point in the last two recessions after which the consumer was able to increase his spending dramatically, thus helping to get the economy out of recession quickly.

Of course, savings are only one component of households' financial assets. In the second quarter net financial investment by households advanced at a record \$603 billion annual rate after declining at a \$78 billion clip in the first quarter. But the major factor accounting for this reversal was a sharp, \$460 billion annual rate jump in the market value of corporate equities held by households, as the stock market rallied mightily in the wake of declining interest rates. However, since then, the stock market has fallen back. At the same time, the savings rate dipped in the third quarter as people stepped up their outlays faster than incomes expanded. This would

suggest that, at the margin, people do not have the wherewithal to fuel additional outlays.

People could turn to credit. The typical household today is in a much more comfortable credit position than it was at the turn of the year, when families had to set aside nearly 18½ per cent of their take-home pay just to service previously incurred debt. The drop in credit usage in the second quarter brought this ratio down to 17 per cent, although it has since gone up a tad. While below the record clip of earlier this year, 17 per cent-plus still represents an above-normal chunk of incomes that must be set aside to service debt.

If consumers are unable to power the economy ahead, perhaps business might. Looking at domestic business, we find that the steep decline in consumer spending left business with large amounts of unsold goods. The ratio of inventories to sales, discounting the disparate effects of inflation on the numerator and the denominator, has come down somewhat from its highs of the summer. However, it is still far above that which prevailed before the economy entered into recession, and it would seem to me that with interest rates as high as they are, businessmen would be reluctant to stock any more goods than they have to. Of course, business could spend more on capital goods and add strength to the economy this way. But this is unlikely to happen while the average operating rate remains in the mid 70s, and while growing chunks of investment funds have to go to comply with pollution control requirements, labor safety regulations or to become more energy-efficient. Not only that, uncertainty about government policies and erratic interest rates are acting to keep capital investment low and deprive the economy of whatever strength it might be able to derive from this source.

When they turn abroad, businessmen are confronted with problems, too. Balance of payments deficits notwithstanding, exports had been one of the true bright spots of the economy for the past couple of years. If the influence of oil is removed from the picture, either through volume or price, it can be seen that our trade picture has been in substantial surplus. Indeed, on the national income accounts basis our overall trade balance actually moved into substantial surplus in the third quarter, to the tune of an \$18.6 billion annual rate. However, any further improvement is likely to be limited, since activity in the economies of our major trading partners has already begun to falter. Most economies of Western Europe are in or very near recession, as is our neighbor to the north, Canada. And even Japan's growth rate has slowed to a mere two per cent, which by her standards is tantamount to a recession. On top of this, the dollar has climbed in value against many currencies, compounding the difficulties that

businessmen will have selling abroad.

That leaves the government sector. There is no question that government spending is rising rapidly. Defense spending, for one, is rising at the fastest rate since the Vietnam War buildup in the mid-1960s. As for nondefense outlays, they are rising rapidly, too, propelled largely by government spending on various types of transfer payments, most of which are indexed to the Consumer Price Index.

But I would question whether rising government spending should be counted as a plus or a minus. This is because this year, for the twelfth consecutive year and the twentieth of the past 21, the Federal government is running a deficit in its budget. Following fiscal year 1980's deficit of \$59 billion, Washington is likely to run anywhere from \$35 to \$40 billion worth of red ink in fiscal year 1981. And that does not include a tax cut. If you factor one in of the dimensions discussed during the 1980 presidential campaign, you could easily come out with a deficit of \$65 billion or more. Plainly, such deficits do not contribute to the economy's health. Indeed, I would say that they undermine it. Either the Federal Reserve must expand the supply of money and credit to help the government finance these deficits without drying up liquidity in the private sector, in which case inflation results, or, if the Federal Reserve holds fast, then interest rates jump up. As I pointed out at the outset, both rising interest rates and rising rates of inflation will either prolong a recession, or cause one.

Conclusions

Where I come out is on the side of those who feel that the economy is likely to turn down again during the fourth quarter, and that recovery will not get underway until 1981. The shape of this recovery as I have observed in the past, is unlikely to be very strong. Indeed, it could very well be marked by some months—or even a full calendar quarter—during which some numbers once again decline. This is because inflation will flare up again before 1981 gets too old, propelled by rising prices for food and fuel, along with increased labor costs. The increased dollar-oriented demands will run up against a Federal Reserve policy designed to keep the monetary aggregates under control. Needless to say, this will cause interest rates to rise sooner than they otherwise would in an economic recovery, thereby constraining the recovery by making it more difficult for businessmen and individuals to borrow. Purchasing power will also be drained by the increase in Social Security taxes next year, the so-called "windfall profits" tax on the oil companies and the effects of moving into higher tax brackets.

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October, 1980
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
in \$ Billions

	< ACTUAL PROJECTED >													
	YEAR 1979		1980				YEAR 1980		1981				YEAR 1981	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	2368.8	11.3	2520.8	2521.3	2583.0	2615.8	2560.2	8.1	2673.9	2747.6	2830.5	2921.3	2793.3	9.1
GNP: \$72	1431.6	2.3	1444.7	1408.6	1412.1	1404.9	1417.6	-1.0	1413.0	1421.4	1428.6	1434.1	1424.3	0.5
% Change, Annual Rates	2.3		1.2	-9.6	1.0	-2.0	-1.0		2.3	2.4	2.0	1.6	0.5	
Consumption	1509.8	11.8	1629.5	1626.6	1681.8	1701.5	1659.8	9.9	1739.0	1776.6	1833.1	1888.6	1809.3	9.0
Durables	213.0	6.4	220.2	195.7	209.3	210.9	209.0	-1.9	217.8	222.5	229.2	240.7	227.5	8.9
Non-Durables	596.9	12.5	652.0	654.1	666.4	675.8	662.1	10.9	689.6	707.7	731.3	752.1	720.2	8.8
Services	699.9	12.9	757.3	776.9	806.1	814.8	788.8	12.7	831.7	846.4	872.6	895.8	861.6	9.2
Investment	387.2	10.1	387.7	368.5	346.0	350.2	363.1	-6.2	367.0	390.7	404.7	418.7	395.3	8.9
Non-Residential	254.9	15.3	272.6	268.2	271.4	270.2	270.6	6.2	270.5	275.2	279.3	288.4	278.4	2.9
Producers Durable Equipment	162.2	12.2	169.4	164.5	169.0	169.8	168.2	3.7	169.1	171.4	171.9	177.6	172.5	2.6
Structures	92.6	21.1	103.3	103.7	102.4	100.4	102.4	10.6	101.4	103.8	107.4	110.8	105.9	3.3
Residential	114.1	5.6	110.4	88.9	92.5	97.5	97.3	-14.7	105.1	112.3	119.7	128.1	116.3	19.5
Inventory Changes	18.1		4.7	11.4	-17.9	-17.6	-4.8		-8.7	3.2	5.6	2.2	0.6	
Net Exports	-4.6		-13.6	-2.2	18.6	16.2	4.8		7.9	6.8	2.7	4.8	5.6	
Government Purchases	476.4	9.4	517.2	528.3	536.7	548.0	532.5	11.8	560.0	573.5	590.0	609.2	583.2	9.5
Federal Defense	108.3	9.3	119.6	124.1	129.1	139.0	128.0	18.2	142.7	147.3	151.5	158.9	150.1	17.3
Federal Civilian	58.4	9.0	66.6	69.2	65.5	68.3	67.4	15.4	70.1	70.5	71.8	73.6	71.5	6.1
State & Local	309.8	9.5	331.0	335.0	342.1	340.7	337.2	8.9	347.2	355.7	366.7	376.7	361.6	7.2
Final Sales: \$72	1421.9	2.7	1444.4	1406.0	1418.9	1414.0	1420.8	-0.1	1417.5	1420.0	1426.0	1433.2	1424.2	0.2
% Change, Annual Rates	2.7		1.5	-10.2	3.7	-1.4	-0.1		1.0	0.7	1.7	2.0	0.2	
GNP Price Index (1972 = 100)	165.5	8.9	174.5	179.0	182.9	186.2	180.6	9.2	189.2	193.3	198.1	203.7	196.1	8.6
% Change, Annual Rates	8.9		9.5	10.7	9.1	7.3	9.2		6.7	8.9	10.4	11.7	8.6	
PCE Deflator (1972 = 100)	163.3	8.9	174.0	178.6	182.3	185.4	180.1	10.3	188.6	192.5	197.3	202.3	195.2	8.4
% Change, Annual Rates	8.9		12.4	11.0	8.5	7.0	10.3		7.1	8.4	10.4	10.5	8.4	
Consumer Price Index (1967 = 100)	217.6	11.3	237.1	244.8	249.1	252.9	246.0	13.0	257.8	265.2	273.8	284.0	270.2	9.9
% Change, Annual Rates	11.3		16.9	13.7	7.2	6.3	13.0		8.0	11.9	13.7	15.8	9.9	
Total Personal Income	1924.2	12.0	2057.4	2080.5	2141.1	2158.3	2109.3	9.6	2194.3	2255.9	2332.6	2410.8	2298.4	9.0
Disposable Personal Income	1624.3	11.4	1737.4	1755.9	1807.5	1821.5	1780.6	9.6	1849.2	1897.6	1960.6	2023.1	1932.6	8.5
Savings Rate	4.5		3.7	4.9	4.6	4.3	4.4		3.7	4.1	4.2	4.4	4.1	
Employment Rate	58.3		58.3	57.6	57.5	57.3	57.7		57.4	57.5	57.6	57.8	57.5	
Unemployment Rate	5.8		6.1	7.5	7.6	7.9	7.3		7.9	7.8	7.9	7.8	7.9	
Indus. Production (1967 = 100)	152.5	4.4	152.5	144.6	141.2	143.2	145.4	-4.7	144.7	146.6	147.1	148.1	146.6	0.9
Housing Starts (000)	1721.9	-14.3	1263.3	1053.0	1408.3	1354.5	1269.8	-26.3	1425.8	1442.7	1540.3	1607.8	1504.2	18.5
Domestic Auto Sales (000)	8358.3	-10.1	7933.3	5504.0	6466.7	6782.8	6671.7	-20.2	6856.1	7086.3	7171.2	7168.1	7070.4	6.0
Corporate Pre-Tax Profits	236.6	14.9	260.4	204.8	226.5	227.9	229.9	-2.8	234.5	236.6	240.2	248.2	239.9	4.3
- Taxes	92.5	9.5	102.4	77.6	86.9	87.5	88.6	-4.2	90.1	91.0	92.4	95.6	92.3	4.1
Net Profits	144.1	18.6	158.0	127.1	139.6	140.4	141.3	-2.0	144.4	145.6	147.8	152.7	147.6	4.5
- Dividend Payments	52.7	11.8	56.6	58.6	59.7	60.5	58.9	11.6	62.0	63.8	65.5	67.3	64.6	9.8
Undistributed Profits	91.4	22.9	101.3	68.5	79.9	79.9	82.4	-9.8	82.4	81.9	82.3	85.4	83.0	0.7
+ Depreciation	131.0	9.3	137.4	139.3	141.4	149.9	142.0	8.4	154.3	158.2	162.2	166.1	160.2	12.8
- Inventory Profits	41.8	65.7	63.2	27.4	36.3	27.4	38.6	-7.6	33.7	38.4	49.4	53.0	43.6	13.1
Net Cash Flow	180.6	6.9	175.5	180.4	185.0	202.4	185.8	2.9	203.0	201.6	195.0	198.5	199.5	7.4